

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Platter of the Appeal of)
ALFR-ED AND ESTELLE COHEN }

Appearances:

For Appellants: Nathan Engelberg, Attorney at Law

For Respondent: F. Edward Caine, Senior Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Alfred and Estelle Cohen to proposed assessments of additional personal income tax in the amounts of \$7,287.00, \$7,410.97, \$4,940.40 and \$4,099.44 for the years 1952, 1953, 1954 and 1955, respectively,

The appeal involves a coin machine business which was operated in Vallejo under the name of Alco Amusement Co. Alco owned or rented bingo pinball machines, music machines and miscellaneous amusement machines. The equipment was placed in bars, restaurants and other locations. The proceeds from each machine after exclusion of expenses claimed by the location owner in connection with the operation of the machine, were divided equally between Alco and the location owner.

As to some of the machines, Alco was operated as a partnership between appellant Alfred Cohen and another person. As to the balance of the machines, Alco was conducted by Cohen as an individual proprietorship. Cohen personally managed the entire business and performed much of the collection work and some of the repair work. One mechanic was employed to do most of the repairs. Cohen's partner was only an investor and did not actively participate in the business.

The reported gross income from the Alco business included only the amounts retained from locations. Deductions were taken for salaries, depreciation, phonograph records and other business expenses. Respondent determined that Alco was renting space in the locations where the machines were placed and that all the coins deposited in the machines constituted gross income to Alco. Respondent also disallowed all expenses pursuant to section 17297(17359 prior to June 6, 1955) of the Revenue and Taxation Code which reads:

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In computing taxable income, no deductions shall be allowed to any taxpayer on any of his gross income derived from illegal activities as defined in Chapters 9, 10 or 10.5 of Title 9 of Part 1 of the Penal Code of California; nor shall any deductions be allowed to any taxpayer on any of his gross income derived from any other activities which tend to promote or to further, or are connected or associated with, such illegal activities,

The evidence **indicates** that the operating arrangements between **Alco** and each location owner were the same as those considered by us in Appeal of Hall, Cal. St. Bd. of Equal., Dec. 29, 1958, 2 CCH Cal. Tax Cas. Par. 201-197, 3 P-H State & Local Tax Serv. Cal. Par. 58145. Our conclusion in Hall that the machine owner and each location owner were engaged in a joint venture in the operation of these machines is, accordingly, **applicable** here.

In Appeal of Advance Automatic Sales Co., Cal. St. Bd. of Equal., Oct. 9, 1962, 3 CSH Cal. Tax Cas. Par. _____, 2 P-H State & Local Tax Serv. Cal. Par. 13288, we held the **ownership** or possession of a pinball machine to be illegal under Penal Code sections 330b, 330.1, and 330.5 if the machine was predominantly a game of chance or if cash was paid to players for unplayed free games, and we also held bingo pinball machines to be predominantly games of **chance**.

Four location owners who had pinball machines from **Alco** testified that they paid cash to players for unplayed free **games**. Three collection reports introduced in evidence show substantial amounts deducted *for expenses*. At the time of respondent's audit, only one out of six location owners interviewed stated that he did not pay out for free **games**.

A book of 50 collection reports was introduced into evidence by appellants as typical collection reports showing no deductions for **expenses**. Cohen, however, admitted the possibility that only the net amounts were entered on them. Moreover, the back of one of these **reports** has penciled numbers which we interpret as showing the amount of expenses **deducted** from the gross proceeds prior to the division of the net proceeds.

We conclude that it was the general practice to pay cash to players of pinball machines for free games not played **off**. Accordingly, the pinball machine phase of the business was illegal both on the ground of ownership and possession of bingo pinball machines, which were predominantly games of chance, and on the ground that cash was paid to winning players. Respondent was therefore correct in applying section 17297,

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Cohen managed the entire Alco business. He did much of the collection work on all types of machines. One mechanic was employed to repair all machines. These factors indicate that there was a substantial connection between the illegal operation of pinball machines and the legal operation of music machines and miscellaneous amusement machines. Respondent was therefore correct in disallowing all the expenses of the Alco Amusement Co,

Except for the three collection reports previously mentioned, there were no records of amounts paid to winning players on pinball machines and respondent estimated these unrecorded amounts as equal to 50 percent of the total amounts deposited in the pinball machines. The 50 percent estimate was based in part on the three collection reports described previously which showed an average payout of 48-1/2 percent.

The estimate was also based on interviews of the owners of six locations which had pinball machines from Alco. One location owner stated payouts for free games were not made. One stated payouts were made but could give no estimate of the amount. The other four locations gave payout estimates of 10 percent, 28 percent, 50 percent and 50 percent, respectively

Respondent's auditor stated that the 50 percent estimate was also based on his experience in interviewing more than 50 persons in connection with investigations of 12 to 15 pinball machine operators. The collection report with numbers on the back mentioned above indicates a gross of \$15.45 and an expense of \$10.45, the expense being 67 percent of the gross.

As we also held in Hall, supra, respondent's computation of gross income is presumptively correct. There were no records of amounts paid to winning players. Appellants offered no evidence that the 50 percent estimate should have been lower and inadvertently offered evidence that it should have been higher. Respondent's method of estimation was reasonable under the circumstances and is sustained.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 28595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Alfred and Estelle Cohen to proposed assessments of additional personal income tax

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in the amounts of \$7,287.00, \$7,410.97, \$4,940.40 and \$4,099.44 for the years 1952, 1953, 1954 and 1955, respectively, be modified in that the gross income is to be recomputed in accordance with the opinion of the board. In all other respects the action of the Franchise Tax Board is sustained,

Done at Pasadena, California, this 27th day of November, 1962, by the State Board of Equalization,

<u>George R. Reilly</u>	Chairman
<u>Richard Nevins</u>	Member
<u>Paul R. Eeake</u>	Member
<u>John W. Lynch</u>	Member
<u></u>	Member

ATTEST: Dixwell L. Pierce, Secretary